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SUBJECT: (SBU) HCMC'S SURPRISING GOLD MARKETS

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11. (SBU) Summary. Not far from HCMC, a huge, 24-karat gold plated effigy of the late Ho Chi Minh on display in Vietnam's largest Buddhist temple is an interesting metaphor for two somewhat incongruous realities: the Vietnamese people's reverence for the founder of Communist Vietnam and their abiding faith in the value of gold and commerce. That faith in gold and commerce is also reflected in the fact that the 2,000 gold dealers located in HCMC comprise what is arguably the most efficient, transparent and least regulated market in the country. Ordinary Vietnamese see gold (often hidden away in walls or under floors) as an investment, a hedge on inflation, a safeguard against unforeseen drastic changes in GVN policy, and the most reliable medium of both exchange and storing wealth. One HCMC financial analyst calls gold the "ultimate local confidence indicator," explaining that when Vietnamese see economic policy drifting away from market reality, they trade in gold. Merchants use gold as a way to avoid taxes or to get around limitations on the purchase and use of foreign exchange and business and individuals alike use the gold markets as the "free market" for exchanging between Vietnamese dong (VND) and U.S. dollars (\$US). Vietnam's gold trading markets can reach a daily turnover of \$3 billion, dwarfing the stock exchange which often records less than \$100 million in turnover. The remarkably versatile role that gold plays in the Vietnamese economy is increasing drawing the attention of senior Vietnamese officials, who are now talking about ways to limit gold trading. Experts warn that, if enacted, such moves would only drive the market underground. Restrictions on gold trading intended to stabilize the value of the VND would almost certainly backfire by removing what has emerged as a key safety valve in Vietnam's mixed state/private economy. End Summary.

The Complex Nature of the HCMC Gold Market

12. (SBU) The price of gold seems to obey strange rules in HCMC. At times, gold can be purchased here for less than on the world market; at other times, such as the days leading up to the exchange and interest rate adjustments announced by the State Bank of Vietnam on November 26, domestic prices can exceed world prices by as much as 20%. According to HCMC-based World Gold Council representative Huynh Trung Khanh, the perplexing behavior of the gold market, especially the divergence between the world and domestic gold price is a function of many factors, including GVN policies that peg the Vietnam Dong (VND) to the USD and limit gold imports in an (eventually unsuccessful) effort to manage the country's balance of payments.

13. (SBU) The State Bank of Vietnam (SBV) sets import quotas for gold and assigns the right to (legally) import gold to roughly a dozen privileged companies. The largest of these are Saigon Gold

and Jewelry Company, Phu Nhuan Gold and Jewelry Company, Sacombank Jewelry, Agribank Gold and Silver Company and the Asia Commercial Bank. According to World Gold Council estimates, Vietnam's gold-consuming industries use between 20 and 22 tons of gold per year, meaning that roughly 70 percent of the 60-some tons of gold that Vietnam imported last year went "into the mattress." Official limitations on gold imports serve as a narrowing of the pipeline rather than a solid impediment. Official limitations on supply mean that local market demand for gold often exceeds the supply, pushing the local price above the world price. The difference between the world and domestic gold prices is held in check gold smuggling. The primary smuggling route is across Vietnam's border with Cambodia and into HCMC's roughly two thousand private gold shops. Those shops pay for the gold using dollars purchased at the "free market" (also called unofficial or "black market") rate. The shops then sell it to Vietnamese buyers either for dollars or for the equivalent VND price based on the prevailing "free market" rate. The industry best guess, based on gold trade throughout the region as well as current and historical consumption patterns, is that between 40 and 50 tons of gold per year are smuggled into Vietnam, and that the stock of privately-held gold in Vietnam ranges from 600 to 700 tons, worth \$22-25 billion USD. To put that into perspective, the value of privately held gold easily exceeds official national reserves.

14. (SBU) "The unofficial currency market is strongly influenced by the price of gold," SBV governor Nguyen Van Giau told the press when he announced the decision to issue additional gold import quotas on November 25. One former multilateral development bank economist seconded that statement in a conversation with the Consulate, attributing significant pressure on the VND/USD "free market" exchange rate to HCMC's 2,000 gold shops buying USD above the official maximum VND/USD exchange rate to purchase gold in Cambodia. This drain on the already restricted flow of hard currency makes it more difficult

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for businesses get the dollars they need for international trade, and obliges the SBV to find other ways to provide more USD liquidity through the banking system.

Gold is Useful for Getting around Inconvenient Rules

15. (SBU) Gold is an important mechanism for getting around official currency exchange constraints, said one expat banker, and will remain so until Vietnam fully liberalizes the VND/USD exchange rate. While gold shops are legally prohibited from conducting foreign exchange transactions, the practice is ubiquitous -- so much so that various GVN-owned media outlets provide daily (or even up to the minute via SMS) "free market" exchange rate quotes. To maintain a semblance of legality, gold shops typically log two transactions when exchanging currency -- gold sale for dollars versus gold purchase for VND at a price that reflect the "free market" VND/USD exchange rate. While banks are legally required to buy and sell dollars within the official trading band, (currently 17,961 VND/dollar plus/minus three percent), many also circumvent the rules by selling gold for dollars then buying the gold with VND with a service charge that just captures the difference between the "free market" and official VND/USD exchange rate.

16. (SBU) For many Vietnamese looking to make large payments, but who don't want to be troubled by paperwork or tax bills, gold remains the currency of choice. While payment in US dollars or even VND was gaining increasing acceptance over the past several years, the disparity between legal and market dollar rates that prevailed for much of 2009 made sellers of real estate and other big ticket items reluctant to put up with exchange rate risks if they accepted VND or the risk that they would be required to exchange their USD for VND at the official rather than free market rate. Gold provides a great, and very traditional, alternative. Except for a few of the larger banks and gold companies like Saigon Jewelry Company and Phu Nhuan Jewelry Company, gold merchants rarely provide tax invoices for gold transactions so the government never needs to know exactly how

much was bought or sold. The "off the books" nature of the gold business is indirectly recognized by the GVN since, as Khanh of the World Gold Council notes, gold shops pay a fixed tax per month rather than a tax on the volume of transactions or on profit.

Gold is an Expression of Confidence, or Lack Thereof

17. (SBU) HCMC bankers and investment fund managers emphasize that gold is a good store of value in high-inflation periods such as Vietnam experienced in 2008. They also explained that gold prices reflect local anxieties about Vietnam's balance of payments and budget deficits, and by extension an expectation of long-term strength or weakness in the Vietnam currency. The real value of Vietnam's currency is based on the strength of the economy, WGC's Khanh agreed, adding that even without high inflation people will buy gold until the currency is fully convertible. Khanh says that although the SBV claims there is no shortage of dollars, the free market exchange rate has yet to converge with the SBV's official maximum rate, which is currently set at 18,479 VND/USD. (Note: As of December 16, the free market rate was 19,400, or roughly 5% above the legal limit.) Until there are enough dollars in the system, that situation won't change and people will look for trusted alternatives like gold.

18. (SBU) The price of gold can also be read as an indicator of confidence, Khanh said, as shown by State Bank of Vietnam macroeconomic moves on November 26. Two days earlier, on November 24, the price of gold in Vietnam at "free market" exchange rates was US\$ 27 per troy ounce above the world price. (Note: Using the "official" exchange rate yielded a domestic Vietnamese gold price a whopping US\$ 221 above the world price -- a figure that was quoted in some local press articles about gold fever. End Note.) Two weeks later, on December 7, the price of gold in Vietnam based upon the free market exchange rate had dropped to US\$ 56 per troy ounce below the world price. These dramatic shifts show that the market read the November 26 exchange rate adjustment as a step toward market reality and greater currency liberalization, a local portfolio investment manager said. Many other HCMC analysts tell us gold is the leading indicator of Vietnamese confidence in their government's economic policies, with several mentioning that the cancellation of short-term interest rate subsidy helped cool fears of a return to high inflation in 2Q 2010.

Time to Regulate Vietnam's Most Efficient Market?

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19. (SBU) One of the secrets to the success of the HCMC gold market is that it largely operates in a legal and regulatory vacuum. A local HCMC equities analyst explained that even though gold imports are regulated, once the gold is in the country domestic trading is so lightly regulated that a huge market has developed in recent years -- a market with daily volumes of reported gold transactions sometimes reaching US\$ 3 billion. In comparison, the HCMC Stock Exchange sometimes closes with less than \$100 million in daily turnover. The analyst said the lack of rules for gold trading have allowed the market to flourish, explaining that "gold is more liquid than Vietnamese stocks, gold transactions settle instantly so you don't wait three days as with stocks, you can short gold, you can leverage gold, ruthless competition minimizes transaction fees, and information is virtually transparent. None of this can be said for stocks in Vietnam."

110. (SBU) This unregulated activity makes some of Vietnam's leaders nervous. SBV governor Nguyen Van Giau told the National Assembly that gold exchanges operate in a "legal loophole" that no agency currently regulates. There is a public discussion over regulating gold, with some like former SBV governor and member of the National Financial and Monetary Policy Advisory Council (NFMPAC) Cao Sy Kiem arguing for strict control over gold trading to help the GVN better manage Vietnam's economy. Most HCMC analysts believe this would just push gold trading

underground. \$1.4 to \$1.8 billion dollars worth of gold will be smuggled into Vietnam this year and the GVN won't be able to turn that off overnight, a gold industry analyst stated. HCMC University of Economic professor and NFMPAC member Tran Hoang Ngan urged caution, "although gold exchanges have negative impacts on the market, the government should facilitate their business with better management."

Comment:

¶11. (SBU) The lesson we take from the operation of the HCMC gold shops is that free markets can and do work remarkably efficiently in Vietnam. With virtually no regulation or oversight, the gold market operates on extremely thin margins; trust in the market is so high that ordinary Vietnamese do not hesitate to engage in fairly large (in comparison to their income) transactions via small gold shops; complaints of non-delivery or debasement are so rare as to be almost a non-issue; and international financial listing routinely list the "SJC" (Saigon Jewelry Company) gold closing prices right alongside prices from New York and Zurich. The broader lesson is that the gold market has been functioning as both a safety valve and reality check on what is happening in more tightly controlled markets such as the official currency exchanges and the stock market. Prior to the November 24 "adjustments" by the SBV, the SBV, GVN -- and everyone else -- only needed to look at the "free market" VND-USD exchange rate set via HCMC's gold shops to understand that the official exchange rate was dangerously out of touch with reality. An attempt to severely restrict the operation of the HCMC gold market would almost certainly have the perverse impact of further undermining confidence in the VND by convincing ordinary Vietnamese that they need to increase their golden hedges against economic uncertainty. End Comment.

Postscript: A Note on the Value of Gold in Vietnam

¶12. (SBU) Gold prices in Vietnam are quoted in obscure measures (like "chi" and "tael" and "luong"). Some reporters quote them at official currency exchange rates that, while binding to international companies, hold less meaning for ordinary Vietnamese while others use free market rates. The results can be confusing. For this cable, we've taken into account official VND/USD exchange rates, "free market" VND/USD exchange rates in HCMC, world gold prices, spot gold prices in Vietnam, and import tariffs. Lastly, Vietnamese gold markets also differ from world markets in that the most commonly quoted price in Vietnam is the delivered price (since Vietnamese traditionally store much of their wealth in gold hidden in their homes or elsewhere). World market prices, on the other hand, do not include the cost of physical delivery since relatively few world buyers actually take possession of the metal they purchase (instead relying on large depositories). We did not attempt to correct for this last difference in world and Vietnamese market prices.

¶13. (U) This cable was coordinated with Embassy Hanoi.
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